Asia Credit Research

OCBC Bank

Neptune Orient Lines Ltd: Credit Update

Friday, 11 March 2016

En Route to Destination

- **Challenging environment persists:** Container freight rates have continued their downwards trajectory, with the Shanghai (Export) Containerized Freight Index declining ~9% during 4Q2015. With high newbuild vessel deliveries through 9M2015, supply pressure was sustained. Coupled with global economic uncertainty, freight rates were driven to historical lows. As a result, NOL's 4Q2015 revenue fell 28.5% y/y to USD1.28bn. Though capacity optimization efforts by NOL kept vessel utilization high, with headhaul utilization at 90%, weakening freight rates (liner revenue / FEU fell 22.0% y/y) and poor backhaul volumes (fell 12.4% y/y) for the quarter drove revenue lower. For the full year, total revenue fell 37.5% to USD5.38bn, largely due to the divestment of APL Logistics earlier in the year. The decline in the remaining liner segment was smaller, but still sizable at 23.8%. With freight rates YTD remaining weak, and no improvements seen in demand, we expect NOL's performance in 1H2016 to remain soft.

- **Core earnings remain pressured**: Though NOL benefitted from: lower bunker fuel prices (USD130mn benefit), cost savings program (USD100mn benefit) and variable cost savings (USD128mn benefit), the combined effects were inadequate to overcome the USD99mn drag from lower volume of work done, as well as the USD288mn drag from lower freight rates. These factors drove core EBIT for the quarter to negative USD65mn, worse than the negative USD36mn generated in 4Q2014. It is worth noting though that core EBIT for the quarter was comparable to the negative USD66mn generated in 3Q2015. The challenging 2H2015 period actually saw USD131mn in core EBIT losses compared to USD33mn in core EBIT gains in 1H2015. In aggregate though, NOL was able to shrink its liner core EBIT losses of USD98mn relative to the USD139mn loss in 2014 (lower bunker fuel was a boon).

- **Cash generation turned negative**: Operating cash flow swung from positive USD69.1mn (3Q2015) to negative USD20.7mn (4Q2015). This was largely due to the year-end pay down of payables (USD100.8mn used during 4Q2015). Coupled with USD15.1mn in capex, NOL generated negative free cash flow of USD35.8mn during the quarter. The cash gap was met partially by ~USD24mn increase in borrowings, with the balance met using NOL's cash balance. As a result, NOL's credit profile deteriorated with net gearing inching higher from 103% (3Q2015) to 106% (4Q2015). Looking forward, we expect NOL to operate at neutral free cash flow or better. For 2015, NOL generated USD166.4mn in free cash flow. We also expect net gearing to remain relatively stable. Net debt / EBITDA improved as well from 14.6x (2014) to 8.5x (2015) as proceeds from the APL Logistics divestment were used to deleverage the firm.

- **CMA CGM 2015 results**: CMA CGM, the third largest container liner and the acquirer of NOL[1], reported USD15.67bn in revenue for 2015, a decline of 6.4% y/y compared to 2014. Comparatively, Maersk's liner segment (the largest player) saw

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revenue fall 13.0% y/y during the year to USD23.41bn, while NOL's revenue fell 23.8% y/y to USD5.38bn. CMA CGM's earnings were robust as well with EBITDA falling 2.8% y/y to USD1.25bn, and net profit falling 4.1% to USD586.7mn. CMA CGM's EBITDA margins actually improved from 7.7% (2014) to 8.0% (2015). For 2015, CMA CGM was able to generate ~USD615mn in free cash flow. Note that CMA CGM's cash balance fell from USD2.19bn (end-2014) to 1.22bn (end-2015) largely due to USD772mn in cash set in escrow for the NOL deal. Interest coverage for 2015 was 4.5x (2014: 4.2x). 4Q2015 results however were pressured, like the rest of the industry. CMA CGM saw revenue for the quarter fall 15.5% y/y to USD3.57bn. Though CMA CGM benefitted from lower bunker fuel, other operational costs were stickier, driving EBITDA lower by 72.0% y/y to USD115.7mn. This drove CMA CGM to a slight quarterly net loss of USD43.9mn, compared to a net profit of USD200.1mn in 4Q2014. As a reference, for Maersk's liner segment revenue fell 24.9% y/y to USD5.13bn for the quarter, while segment EBITDA fell 68.7% y/y to USD359.0mn.

- **Pro-forma balance sheet**: CMA CGM ended 2015 with net gearing of 73%, an increase from 66% as of end-2014. Gross borrowings actually fell from USD5,480mn (end-2014) to USD5,148mn (end-2015). The increase in net gearing was due in part to cash set aside in escrow for the NOL deal. Adjusting for this, net gearing ending 2015 would have been 58%. Post the merger, we have estimated pro-forma net gearing to be 134% (assuming USD1bn of assets are divested to pay down debt, USD1652mn debt financing and USD772mn from cash from CMA CGM). Net debt / EBITDA would be 4.6x. Looking forward, we expect CMA CGM to deleverage post the merger. CMA CGM had previously deleveraged from a net gearing of 141% (end-2011) to 66% (end-2014).

- **CMA CGM merger proceeding as planned**: CMA CGM has been consistently buying shares of NOL in the secondary market (at ~SGD1.25 per share compared to the offer price of SGD1.30). Currently, CMA CGM owns 4.8% of NOL. CMA CGM has recently announced as well that the European Commission would provide its ruling (regarding antitrust) on the merger by 15th April. The original timeline was to obtain all antitrust regulatory approvals by the middle of 2016, and to execute the deal 60 days post the completion of closing conditions (including antitrust approvals). Our base case continues to be that the merger will go through.

- **Industry consolidation continuing**: With the two Chinese liners, COSCO and China Shipping Group, having merged to form the fourth largest container liner, the pace of consolidation continues. Though the intent is for NOL to remain part of the G6 alliance for the rest of 2016 post the merger, there are some market news that CMA CGM – NOL is considering forming a new mega alliance with COSCO – China Shipping Group, Evergreen and OOCL[2]. We continue to believe that with the capacity supply overhang, there is a need for further consolidation in the industry, and that NOL would benefit from being part of a bigger entity.

- **Recommendation**: We believe that the CMA CGM – NOL merger is proceeding, and that NOL would ultimately benefit operationally as part of the CMA CGM group. Though leverage for CMG CGM would increase, our expectation is that the group would deleverage, as it had in the past, to a more manageable credit profile. 2015 full year results are as expected, with CMA CGM having outperformed some of its peers. As such, **we retain out Neutral Issuer Profile on NOL**. As for specific bond recommendations, technical factors remain poor, with investors still trying to calibrate the NOL curve. The NOLSP'17s have dipped a couple of points from par (5.7% YTM before CoC step-up), while the longer dated bonds have sold off sharply, trading at distressed levels of 19.3% YTM (52c offer) for the NOLSP'21s. We believe that the selloff is overdone for a performing credit and have recently **upgraded the curve to Overweight**[3].

[2] WSJ – CMA CGM confirms alliance talks – 24/02/16
[3] OCBC Asia Credit Monthly (March 2016)

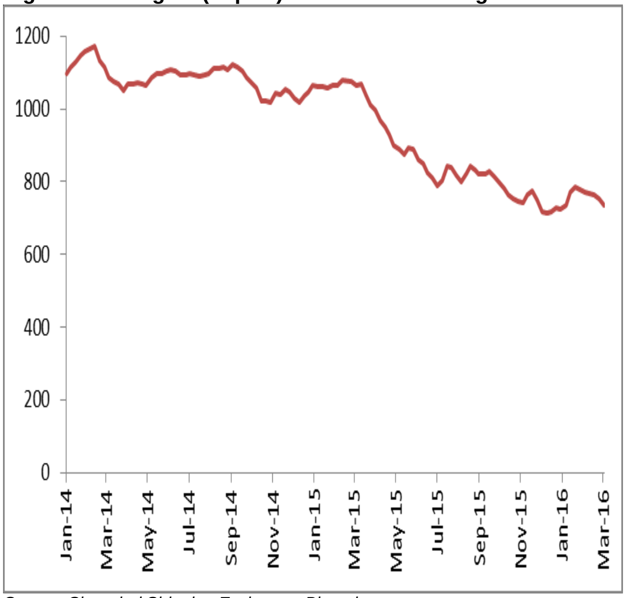
Neptune Orient Lines Ltd

Table 1: Summary financials

Year ended 28th December	FY2013	FY2014	FY2015
Income statement (US$ mn)			
Revenue	8,831.2	8,616.8	5,382.6
EBITDA	117.2	278.4	311.5
EBIT	-199.9	-114.1	-72.0
Gross interest expense	50.7	125.9	125.5
Profit before tax	-15.8	-216.9	712.2
Net income	-76.3	-259.8	707.2
Balance sheet (US$ mn)			
Cash and equivalents	981.0	1,225.8	229.9
Total assets	9,029.0	9,099.6	6,908.7
Gross debt	4,865.9	5,291.4	2,882.4
Net debt	3,885.0	4,065.6	2,652.5
Total equity	2,130.8	1,807.9	2,492.6
Total capitalization	6,996.8	7,099.3	5,374.9
Net capitalization	6,015.8	5,873.5	5,145.0
Cash flow (US$ mn)			
Funds from operations (FFO)	240.9	132.7	1,090.7
CFO	31.6	68.8	276.9
Capex	1,308.0	350.3	110.5
Acquisitions	-23.8	-28.1	21.9
Disposals	442.9	68.5	1,158.2
Dividends	-3.0	-4.2	10.3
Free Cash Flow (FCF)	-1,276.4	-281.6	166.4
Adjusted FCF*	-860.3	-245.3	1,292.4
Key ratios			
EBITDA margin (%)	1.3	3.2	5.8
Net margin (%)	-0.9	-3.0	13.1
Gross debt/EBITDA (x)	41.5	19.0	9.3
Net debt/EBITDA (x)	33.1	14.6	8.5
Gross debt/equity (x)	2.28	2.93	1.16
Net debt/equity (x)	1.82	2.25	1.06
Gross debt/total capitalization (%)	69.5	74.5	53.6
Net debt/net capitalization (%)	64.6	69.2	51.6
Cash/current borrowings (x)	1.64	1.99	0.4
EBITDA/gross interest (x)	2.3	2.2	2.5

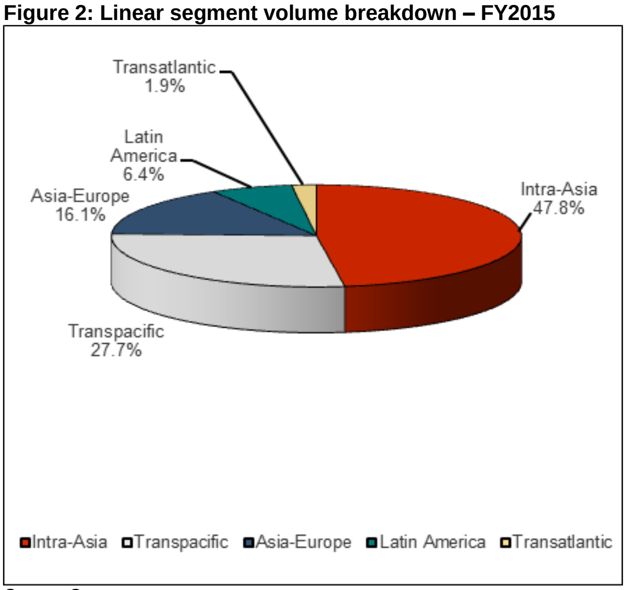
Source: Company, OCBC estimates
**Adjusted FCF = FCF –Acquisitions – Dividends + Disposals*

Figure 1: Shanghai (Export) Containerized Freight Index



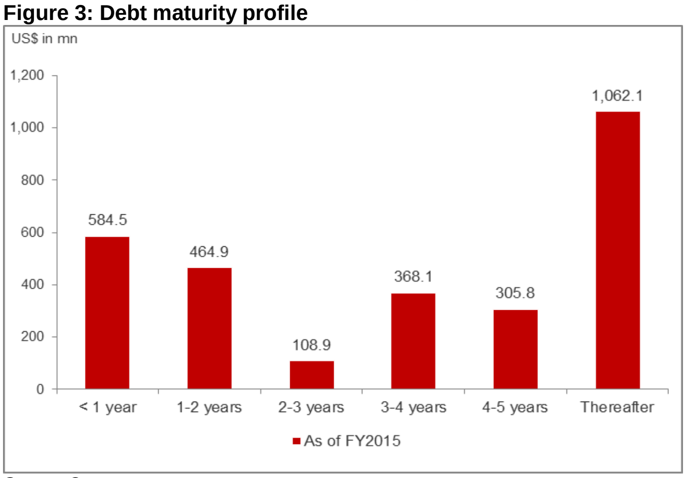
Source: Shanghai Shipping Exchange, Bloomberg

Figure 2: Linear segment volume breakdown – FY2015



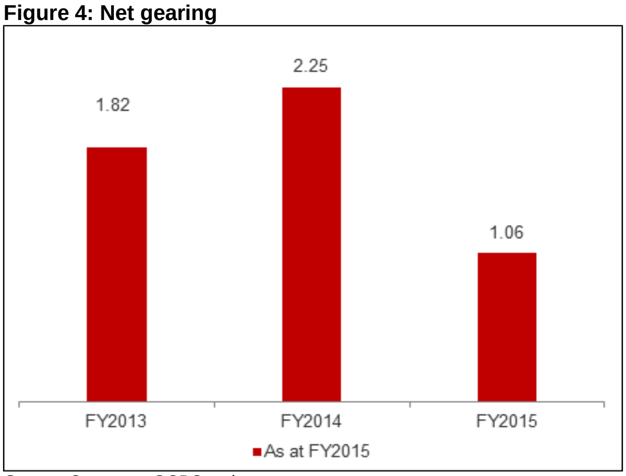
Source: Company

Figure 3: Debt maturity profile



Source: Company

Figure 4: Net gearing



Source: Company, OCBC estimates